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The Tax Consequences of Settling an Employment Claim

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Settling an employment lawsuit involves the complicated process of finding that magic number. How much will the plaintiff take, and the defendant pay, to forgo the cost, effort, and risk of taking the case to trial? Of course, in some cases, no amount of money—however high or low—will keep the plaintiff from having her day in court, or keep the defendant from exposing the frivolity of the plaintiff's claims. But when an acceptable number does exist, counsel must understand the tax consequences of settling an employment dispute, and must adequately address those consequences in the settlement agreement. Otherwise, the fight between the parties will continue when the IRS comes looking for the government's portion of that "magic number." This article provides four guidelines for understanding and addressing the tax consequences of settling an employment claim.

Guideline #1: Almost *All* Settlement Proceeds Are Included in Plaintiff's Taxable Income.

As a general rule, nearly all settlement payments in an employment lawsuit are included in the plaintiff's taxable income. This includes payments for back wages, front pay, emotional distress damages, interest awards, and punitive/liquidated damages. The only exceptions to this general rule are: (1) certain payments for attorneys' fees (which are discussed below in Guideline #2); and (2) payments intended to compensate the plaintiff for damages "on account of personal *physical* injuries or *physical* sickness." I.R.C. § 104(a)(2) (emphasis added). In addition, payments for mental anguish are not taxable if they do not exceed the actual medical expenses attributable to the emotional distress. I.R.C. §§ 61, 104(a)(2).

To exclude a settlement recovery (or any portion thereof) from taxation under section 104(a)(2)'s "physical injury/sickness" exception, the taxpayer must show that the settlement payment was received "on account of personal *physical* injuries or *physical* sickness." *Id*. (emphasis added). The key to excluding settlement proceeds from gross income under section 104(a)(2) is establishing that the taxpayer suffered observable or documented bodily harm, such as bruising, cuts, swelling or bleeding. *See IRS Counsel Memorandum*, Income and Employment Tax Consequences and Proper Reporting of Employment-Related Judgments and Settlements (Oct. 22, 2008). If the plaintiff did not suffer these types of observable physical injuries as a result of the conduct in question, she is not eligible to exclude any portion of the settlement proceeds under section 104(a)(2). However, if the plaintiff did suffer these types of observable physical injuries, the plaintiff may exclude any settlement proceeds intended to compensate her for these injuries, and for other damages caused by these injuries. For example, if the plaintiff was sexually assaulted by a supervisor and asserts a hostile work environment claim, the plaintiff may exclude any settlement amounts paid as compensation for: (1) the physical injuries suffered in the assault, (2) emotional distress arising out of the plaintiff's physical injuries, and (3) wages lost because of the plaintiff's physical injuries. However, settlement payments for physical symptoms that result solely from emotional distress unrelated to any observable physical injuries are not excludable under section 104(a)(2). *See* I.R.C. § 104(a)(2); H.R. Rep. No. 104-737, at 301 n. 56 (1996) (Conf. Rep.)., 1996-3 C.B. 741, 1041.

Most employment-related disputes do not involve physical injuries, such as bruising, cuts, swelling, or bleeding. Instead, the injuries typical in employment cases (such as insomnia, headaches, weight loss, stomach disorders, etc.) are related to the emotional distress allegedly caused by being discriminated against, or by being subjected to a hostile work environment. Settlement payments to compensate for these types of "soft" injuries are not "on account of a" physical injury or physical sickness, and are, therefore, not excludable from the plaintiff's gross income under section 104(a)(2). *Id.* Thus, absent a claim involving a battery, settlements for injuries in an employment case will generally be included in the plaintiff's gross income.

Guideline #2: Settlement Payments for Attorneys' Fees Are Generally Included in Plaintiff's Taxable Income.

As another general rule, attorneys' fees received in settlement of an employment dispute are taxable to the plaintiff, even if the fees are owed or paid directly to the plaintiff's attorneys. However, this rule is also not without exception. The first exception where settlement payments for the plaintiff's attorneys' fees are not included in the plaintiff's gross income is when the attorneys' fees and costs are associated with the recovery of nontaxable physical injury/sickness payments (*see* Guideline #1). Because physical injuries/sicknesses are relatively uncommon in employment disputes, this exception has limited use in the employment context.

Second, attorneys' fees paid directly to class counsel out of a settlement fund are not included in a class member's gross income if: (1) the class member did not have a separate contingency fee arrangement or retainer agreement with class counsel; and (2) the class action was an opt-out class action. *See* PLR 200625031; PLR 200610003; PLR 200609014; PLR 200551008; *Sinyard v. Commissioner*, T.C. Memo. 1998-364, *aff'd*, 268 F.3d 756 (9th Cir. 2001).

Third, attorneys' fees that are expenses of another person or entity are not taxable income to the plaintiff. For example, when a union files claims against a company on behalf of its members and subsequently obtains a settlement that includes the payment of attorneys' fees, the union members do not need to report the payment for attorneys' fees in their taxable income. *See Erickson & Mirsky*, Tax Consequences of Employment Cases, Journal of Compensation and Benefits, November/December 2009.

And the final twist concerning the taxability of attorneys' fee payments in employment settlements is that, while payments for attorneys' fees must be included in plaintiff's gross income, they can often times be deducted above the line when calculating the plaintiff's adjusted gross income. *See* I.R.C. §§ 62(a)(20); 62(e). Specifically, above-the-line deductions for attorneys' fees are permitted when the plaintiff receives fees in settlement of claims under the following employment statutes: the Civil Rights Act of 1991, the National Labor Relations Act, the Fair Labor Standards Act, the Age Discrimination in Employment Act, the Rehabilitation Act of 1973, the Employee Retirement Income Security Act, the Employee Polygraph Protection Act of 1988, the Worker Adjustment and Retraining Notification Act, the Family and Medical Leave Act, Title VII, the Uniformed Services Employment and Reemployment Rights Act, the Americans With Disabilities Act, federal whistleblower statutes, and any state or local equivalents of the aforementioned laws. *See* I.R.C. §62(e). Plaintiffs who receive attorneys' fees in settlement of claims brought under employment statutes not listed above may deduct the fees on Schedule A as miscellaneous itemized deductions, which are subject to the 2% floor of I.R.C. § 67. Any above-the-line deduction under section 62(a)(20) is limited to the amount of the award includable in the plaintiff's income for the year in which the deduction is taken. *See IRS Counsel Memorandum*, Income and Employment Tax Consequences and Proper Reporting of Employment-Related Judgments and Settlements (Oct. 22, 2008).

Other attorneys' fee issues that frequently arise in employment settlements include "how many checks should the employer issue?" and "to whom should they be made payable?" The bottom line here is that neither the number of checks, nor the payee(s) affect the general rule that settlement payments

for attorneys' fees are included in the plaintiff's gross income. However, the number of checks and the payees will affect how the parties must report the settlement payments.

If the employer only issues one check for the entire settlement payment (including attorneys' fees) made payable jointly to plaintiff and her attorneys, the employer will need to issue a Form-1099 MISC to the attorneys and the plaintiff for the entire amount of the settlement payment, even though the attorneys disbursed most of the settlement to the plaintiff. To avoid this issue, the attorneys may insist on two checks: one to the attorneys for their fees, and one to the plaintiff for the remaining balance. In this instance, the attorneys will only receive a 1099-MISC for the amount of the attorneys' fee payment, which will simplify matters when the attorneys are reporting their taxes.

Guideline #3: Settlement Agreement Generally Controls Tax Treatment of Payments.

The plaintiff/taxpayer has the burden of demonstrating that settlement proceeds (or any portion thereof) are excludable from her taxable income. *See e.g.,* Getty v. Commissioner, 913 F.2d 1486 (9th Cir. 1990). Specifically, the plaintiff must show the portions of the settlement proceeds that were intended to compensate the plaintiff for excludable items, such as attorneys' fees and damages "on account of personal *physical* injuries or *physical* sickness." I.R.C. § 104(a)(2) (emphasis added). To help meet the burden of proving that the settlement proceeds are excludable, counsel should include an express allocation of the proceeds in the settlement agreement. When a settlement agreement expressly allocates the settlement proceeds among various types of damages, the allocation is generally binding for tax purposes, as long as the agreement is entered into by the parties in an adversarial context, at arm's length, and in good faith. *See e.g.*, Bagley v. Commissioner, 105 T.C. 396, 406 (1995), *aff'd* 121 F.3d 393 (8th Cir. 1997). An express allocation will only be disregarded where the facts and circumstances surrounding the underlying case indicate that the payment was intended to be for a different purpose.

The key inquiry in evaluating the authenticity of a settlement allocation is the employer's intent when it paid the settlement. *See* Knuckles v. Commissioner, 349 F.2d 610, 613 (10th Cir. 1965); Agar v. Commissioner, 290 F.2d 283, 284 (2d Cir. 1961). In other words, in lieu of what was the settlement paid? *See Robinson v. Commission*, 102 T.C. 116, 126 (1994) (emphasis in original). Although the employee's belief is relevant to the inquiry, the character of the settlement payment hinges ultimately on the employer's dominant reason for making the payment. *See Agar*, 290 F.2d at 284.

Importantly, employers should take precautions to protect themselves from unanticipated tax burdens in the event the settlement allocation is ever challenged. For example, employers could insist on the inclusion of an indemnification provision in the settlement agreement, such as the following:

> "*[Plaintiff] agrees that, should any taxing authority assess any taxes, penalties or interest against either [Plaintiff] or [Employer] as a result of the settlement payments, [Plaintiff] will be solely responsible for the taxes, penalties, or interest, if any, which may be owed to any governmental agency as a result of the settlement payments, and [Plaintiff] agrees that he will indemnify, defend, and hold harmless [Employer] for any such taxes, penalties, or interest.*"

An indemnity provision such as the preceding one should obligate the plaintiff to indemnify and defend the employer if the IRS ever challenges the settlement allocation. However, because individual plaintiffs ordinarily do not have the resources to engage in protracted litigation with the IRS, indemnification provisions may be of little practical value. Therefore, in addition to the indemnification provision, employers should always insist on a settlement allocation that accurately reflects the circumstances and substance of the settled claims.

Guideline #4: Settlement Payments Create Reporting and Withholding Obligations.

The payment of a settlement imposes reporting obligations on the parties, which depend on the nature of the settlement proceeds. There are two primary methods in which a settlement (or a portion of a settlement) may be reported to the I.R.S.: (1) Treasury Form W-2; and (2) Treasury Form 1099-MISC as "other income."

Any portion of the settlement proceeds paid to compensate for wages must be reported through Form W-2, and will essentially be treated by the employer as a payroll check. *See* I.R.C. § 6051. The employer will deduct applicable taxes and withholdings for Social Security and Medicare, and will remit the matching taxes to the IRS. *See* I.R.C. § 3402(a). Any portion of the settlement proceeds paid for non-wages are typically reported through Form 1099-MISC as "other income." *See* I.R.C. § 6041. The employer will not deduct any taxes or withholding and will not remit any matching taxes on these non-wage payments.

Plaintiffs often request that employers treat the entire settlement payment as "other income" under Form 1099-MISC, to avoid the deduction of taxes and withholdings. While this practice may temporarily result in a larger settlement check for the plaintiff, it subjects both the employer and the employee to substantial potential tax liability. If portions of the settlement proceeds are misclassified as "other income" when, in fact, they are wages, the plaintiff will be responsible for all taxes, including the employer's portion. If the employee is unable to satisfy the tax burden of settlement proceeds, the IRS will likely turn to the employer for payment. In addition, if an employer fails to deduct and withhold income tax amounts by treating the employee or former employee as a nonemployee, the employer may be subject to additional liability, penalties, and interest. *See* I.R.C. § 3509. Thus, employers should again insist on a settlement allocation that accurately reflects the circumstances and substance of the employment claims settled, and specifically should generally not agree to treat the entire settlement as "other income" under Form 1099-MISC.

Conclusion

The tax consequences of settling an employment claim can be significant, and depend on the specific facts of each case. Therefore, employers, employees, and their attorneys should carefully consider these consequences before reaching a settlement, and should strongly consider consulting with tax practitioners concerning this complex and ever-changing area of the law.